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AMERICA'S INTERNATIONAL DEVELOPMENT AGENDA

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The international community frequently demands that wealthy nations increase their development assistance to poor nations. The United States will provide additional assistance, but President Bush is also prudently pursuing a system that measures the effectiveness of aid.

In the days leading up to the International Conference on Financing for Development, held in Monterrey, Mexico, from March 18 to 22, 2002, both World Bank President James Wolfenson and United Nations Secretary General Kofi Annan called for the United States to double its contribution to development assistance.[1] Oxfam, an international aid organization, claims that 56 million children will die needlessly over the next 15 years if wealthy nations do not provide an extra $100 billion each year in aid.[2]

In the wake of these calls for increased international aid, President George W. Bush proposed increasing America's development assistance budget by $10 billion over a three-year period.[3]

Current plans are to increase development assistance by $1.7 billion in 2004, $3.3 billion in 2005, and $5 billion in 2006.[4]

This is no capitulation to international pressure, however. President Bush's

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1. United Nations Press Release, "Kofi Annan Urges World Leaders to Double Aid to Poor Countries," March 22, 2002. See also James Wolfenson, "A Partnership for Development Peace," World Bank, March 6, 2002. These calls are partially based on a 1970 resolution by the U. N. General Assembly setting a target of 0.7 percent of GNP in development assistance for developed nations.
2. Kevin Watkins, "Last Chance in Monterrey: Meeting the Challenge of Poverty Reduction," Oxfam *Briefing Paper*, March 13, 2002, p. 5.
3. "President Proposes $5 Billion Plan to Help Developing Nations," Remarks by President George W. Bush on Global Development at the Inter-American Development Bank, Office of the Press Secretary, March 14, 2002, at *http://www.whitehouse.gov/news/releases/2002/03/print/20020314-7.html*. Treasury Secretary Paul O'Neill subsequently noted that the President's proposal was an increase of $10 billion over three years rather than a $5 billion increase.
4. John Nagel and Nancy Ognanovich, "O'Neill Says Cumulative Development Aid Will Increase $10 Billion over Three Years," Bureau of National Affairs *Daily Report for Executives*, March 21, 2002.

proposal seeks to use that additional assistance to improve the effectiveness of aid through a "Millennium Challenge Account" that would disburse aid only to countries that show improvement in rooting out corruption, raising health and education standards, or promoting economic freedom. Countries that do not make such improvements would not be eligible.

Thus, the Millennium Challenge Account would encourage economic development by creating a positive competition among potential recipients, with this competition rewarding those countries that adopt policies that help their citizens.

Although President Bush has identified broad criteria for distributing foreign aid, he has not specified how progress in the various categories would be measured. In designing a mechanism to do so, he should stress the critical impact that economic freedom has on the per-capita GDP of a country's citizens as well as on a spectrum of standard-of-living indices.

In sum, to ensure the effectiveness of U.S. aid, President Bush should:

1. **Allocate** foreign aid based on improvements in economic freedom.
2. **Stress** the benefits of economic freedom, both in terms of economic development and in terms of improvements in standards of living.
3. **Administer** the foreign aid in the Millennium Challenge Account in the form of grants rather than loans.

By adopting these measures, President Bush would radically transform the way in which the United States administers bilateral aid and would set the stage for significant changes in America's policy toward disbursement of multilateral aid, helping to ensure that U.S. taxpayers' dollars are being allocated wisely.

FAILURES OF TRADITIONAL FOREIGN AID

Experience has demonstrated that development assistance (i.e., government-to-government assistance intended to catalyze development in poor nations) is not a key factor in increasing economic growth in underdeveloped countries. On the contrary, development assistance has often proved to be counterproductive.

Throughout the past 50 years, the United States has given more than $500 billion in foreign assistance to less-developed countries.[5] Yet the people in many of these countries are no better off today in terms of per-capita gross domestic product (GDP) than they were decades ago; some, in fact, are actually poorer. Zambia, for example, has received U.S. foreign aid for four decades;[6] despite more than $1 billion (in constant 1999 U.S. dollars) in bilateral economic aid from the United States,[7] however, Zambia's real GDP per capita has fallen by almost 50 percent, from $664 in 1964 to $338 in 1999.[8]

The dismal failure of development assistance to catalyze economic growth characterizes multilateral as well as bilateral lending institutions. For instance, in sub-Saharan Africa, 17 countries experienced a decline in real per-capita gross national product (GNP) between 1970 and 1999 despite receiving well over $100 billion in World Bank assistance.[9]

The responsibility for economic growth in underdeveloped countries lies largely with the government of each country, since the primary determinant of economic growth is a country's own institutions and policies. Countries with institutions and policies that promote economic freedom tend to have higher per-capita incomes, on average, than countries that do not embrace economic freedom. A 1997 World Bank analysis of foreign aid underscored this premise, finding that assistance "has a positive impact on growth in countries with good fiscal, monetary, and trade policies."[10] Con-

5. Denise H. Froning, "U.S. Foreign Aid Program," in Stuart M. Butler and Kim R. Holmes, eds., *Issues 2000: The Candidate's Briefing Book* (Washington, D.C.: The Heritage Foundation, 2000), p. 800.
6. *Ibid.*, pp. 803–804.
7. Organization for Economic Cooperation and Development, *International Development Statistics 2002*.
8. World Bank Group, *World Development Indicators 2001*.
9. *Ibid.*

versely, countries with poor economic policies did not experience sustained economic growth, regardless of the amount of assistance they received.[11]

A more recent World Bank report claiming that aid has not been as much of a failure as most critics assert should be treated with caution.[12] The report cites the progress made by Vietnam, China, India, Uganda, Poland, and Mozambique as foreign aid success stories; but although these countries did experience significant economic growth, they received relatively little development assistance, and their achievements should not be attributed to that aid. For example, aid to China and India averaged 0.4 percent and 0.7 percent of GDP, respectively, during the period covered by the World Bank report (the 1980s and 1990s). Poland and Vietnam also received development aid that was below average.[13]

The only major aid recipient among these countries, Mozambique, not coincidentally is also the second most improved nation in terms of economic freedom since the *Index of Economic Freedom* first began ranking countries in 1995.[14] Other African countries, by contrast, have seen the ratio of aid as a percent of GDP rise steadily over the past 20 years to about 16 percent of GDP in 1999. Yet the average rate of economic growth of sub-Saharan African countries was barely above 0 percent in 1999 because, unlike Mozambique, they failed to make improvements in economic freedom.[15]

Moreover, the World Bank report ignores the fact that just as many low-income aid recipients experienced negative rates of growth in real per-capita income as experienced positive growth rates during the 1990s. Despite the World Bank's claims regarding the benefits of development assistance, the evidence shows that foreign aid is not an important factor in promoting economic development. As noted by former World Bank economist William Easterly, "Among all low-income countries, there is not a clear relationship between aid and growth."[16]

Rather than repeat past mistakes by indiscriminately increasing the amount of aid given to underdeveloped countries, President Bush should employ criteria that would maximize the effectiveness of U.S. aid in promoting development—or at least ensure that it does not undermine development by rewarding countries with bad economic policies.

THE POSITIVE IMPACT OF ECONOMIC FREEDOM

The primary determinant of economic development is a country's own economic policies: Economically free countries experience higher per-capita incomes, on average, than countries that are not free. This analysis is supported by the *Index of Economic Freedom*, an annual survey that measures economic freedom in 161 countries by ranking their economies on a scale from 1 ("free") to 5 ("repressed"). As Chart 1 shows, countries rated as "free" in the 2002 edition of the *Index* had an average per-capita income of $23,325, while countries rated as "repressed" averaged only $3,829.[17]

Increased Entrepreneurship and Per-Capita Income. Economically free countries tend to have higher per-capita incomes than those with economies that are not free because individuals and businesses in those countries are more likely to undertake entrepreneurial ventures.

10. Craig Burnside and David Dollar, "Aid, Policies, and Growth," World Bank, Policy Research Department, Macroeconomic and Growth Division, June 1997, cover.

11. David Dollar and Lant Pritchett, *Assessing Aid: What Works, What Doesn't and Why*, World Bank Policy Research Report, 1998, p. 2.

12. Nicholas Stern, Ian Goldin, and Halsey Rogers, "The Role and Effectiveness of Development Assistance: Lessons from World Bank Experience," World Bank, March 2002, at *http://econ.worldbank.org/files/13080_Development_Effectiveness.pdf*.

13. William Easterly, "The Cartel of Good Intentions: Bureaucracy Versus Markets in Foreign Aid," Institute for International Economics, Center for Global Development, March 2002, p. 32.

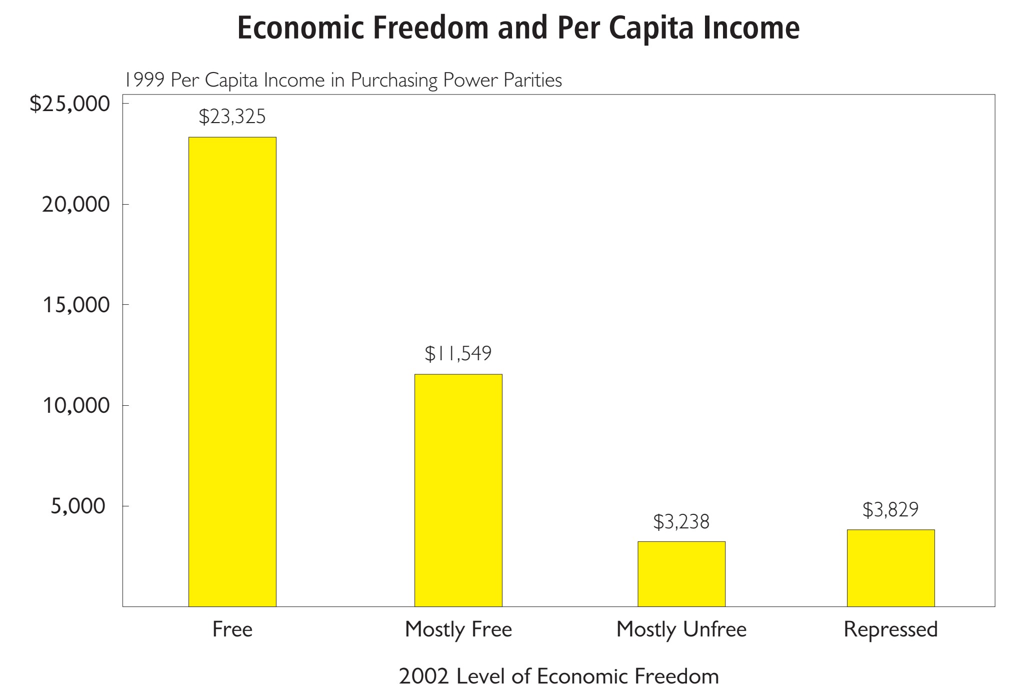
14. Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Mary Anastasia O'Grady, *2002 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2002), p. 7.

15. Easterly, "The Cartel of Good Intentions," p. 26.

16. *Ibid.*, p. 32.

17. O'Driscoll, Holmes, and O'Grady, *2002 Index of Economic Freedom*, p. 2.

Chart 1 B1546



Sources: *2002 Index of Economic Freedom*, The Heritage Foundation and *The Wall Street Journal* and *World Development Indicators 2001*, The World Bank Group.

Countries that maintain policies that promote economic freedom provide an environment that facilitates trade and encourages entrepreneurial activity, which in turn generates economic growth.

A recent study by economists Richard Roll and John Talbott supports this conclusion with evidence that more than 80 percent of the international variation in real income per capita between 1995 and 1999 in more than 130 countries can be explained by the economic, legal, and political institutions of a country. The authors found that the variables that had the most consistent and positive influence on a country's per-capita income were strong property rights, political rights, civil liberties, press freedom, and government expenditures. Conversely, the variables that had a negative effect on per-capita income included excessive regulation, poor monetary policy, black market activity, and trade barriers.[19]

Of these nine variables, those that had the greatest effect on explaining variations in per-capita income were strong property rights and black market activity. Roll and Talbott found a strong relationship between economic freedom and the level of per-capita income in a country, concluding that economic freedom is clearly important to a country's development:

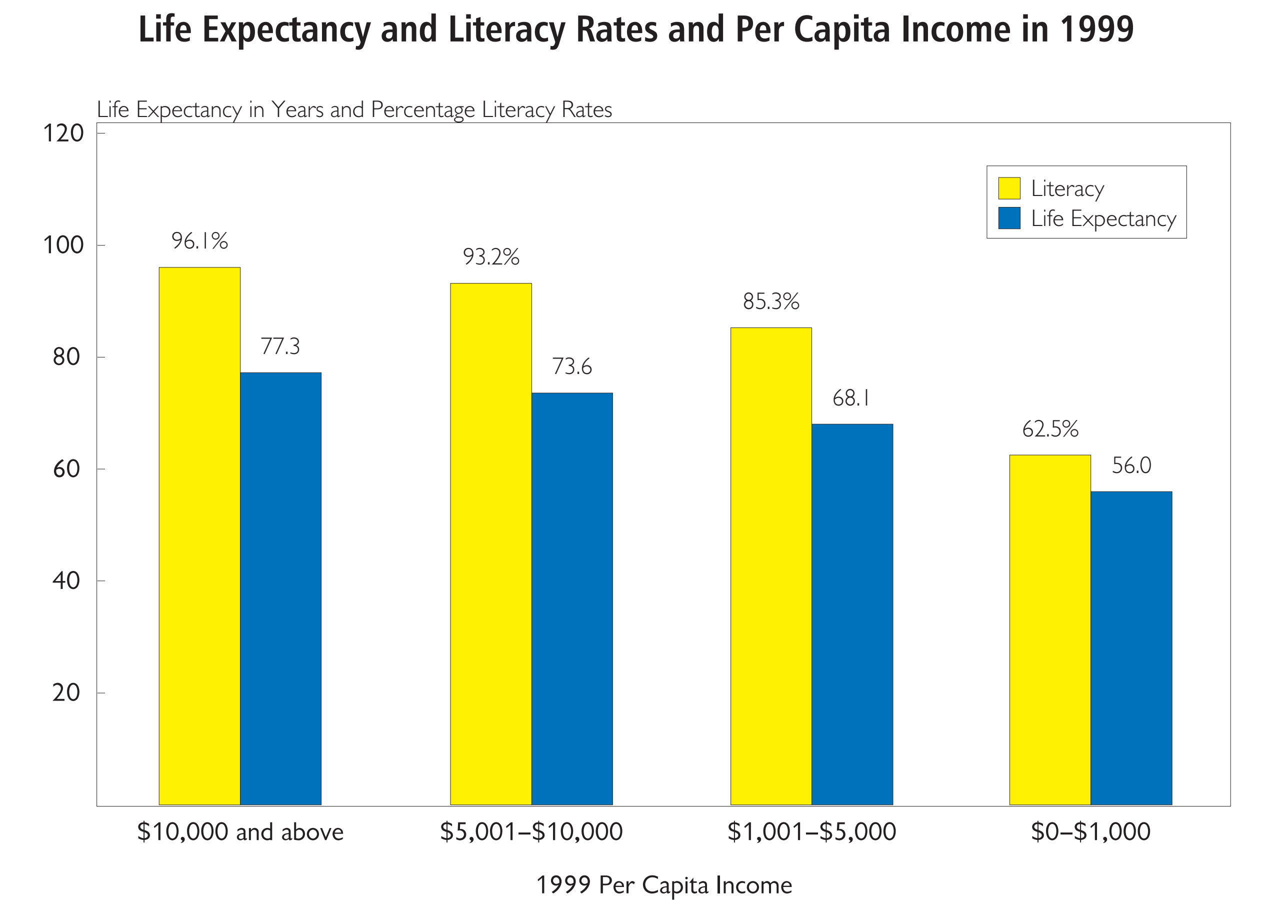
> Economic participants cannot save in a world of inflationary government-sponsored counterfeiting. They cannot compete with state-sponsored monopolies.

Specifically, individuals are more likely to establish a business in a country in which property rights are secure and the level of regulation is low. Countries with low trade barriers are able to increase per-capita income by facilitating the exchange of goods and services between their businesses and those of other countries. Strong property rights reduce the risk and cost of such activities. According to economists Lee Hoskins and Ana Eiras:

> for individuals to work, save, and invest, and for firms to begin operations or expand existing activities, they need to be secure in the knowledge that they will be the full owners of their property and that nobody will take it from them. The greater the protection of property, the more individuals and firms will embark on all sorts of economic activities, thereby propelling economic growth.[18]

18. Lee Hoskins and Ana Eiras, "Property Rights: The Key to Economic Growth," in O'Driscoll, Holmes, and O'Grady, *2002 Index of Economic Freedom*, p. 38.
19. Richard Roll and John Talbott, "Developing Countries that Aren't," unpublished manuscript, November 13, 2001, p. 3.

Chart 2 B1546



Source: *World Development Indicators 2001*, The World Bank Group.

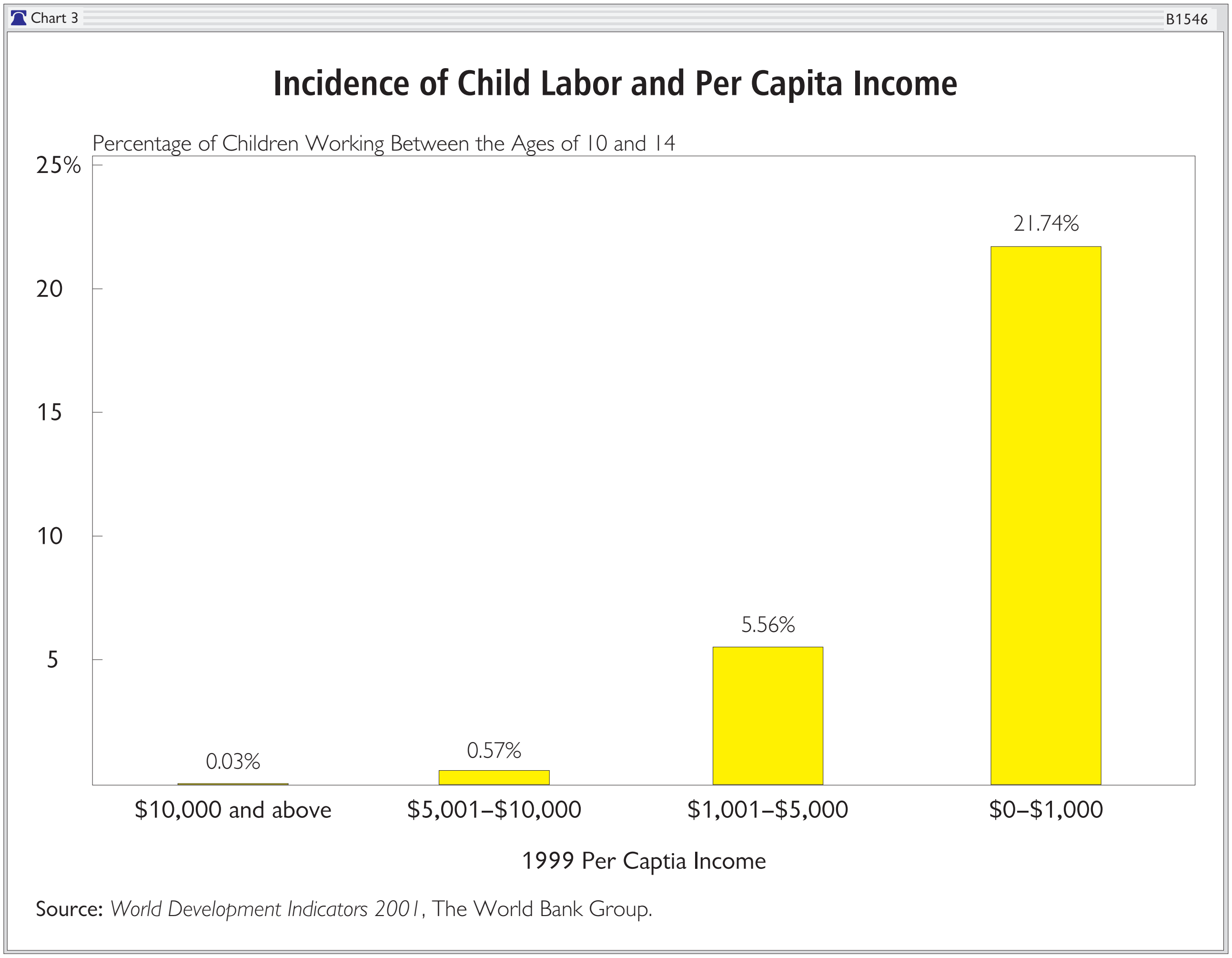
> They cannot trade efficiently with the existence of high tariffs and phony official exchange rates. They cannot easily overcome burdensome regulation and corruption. They cannot capitalize future profits in a world devoid of property rights. And they cannot prosper without economic and personal freedoms.[20]

There are numerous examples of countries that increased their per-capita income after embracing economic freedom. Fifty years ago, Hong Kong, South Korea, and Singapore were as poor as—if not poorer than—many developing countries are now, but today all three have high per-capita incomes. Real income per capita in Hong Kong in 1999 was 7.3 times larger than it was in 1960, while it was 9.6 times larger in Korea and 9.8 times larger in Singapore. In contrast, in sub-Saharan African countries—which have lacked economic freedom—real income per capita was only 1.2 times greater in 1999 than it was in 1960.[21] Experience has demonstrated that economic freedom is the best way to increase per-capita income in countries in all regions of the world.

Improved Standard of Living. Experience has also demonstrated that countries with higher per-capita incomes tend to have higher education, health, labor, and environmental standards. Such countries are able to raise the standard of living for their citizens because they are able to make greater investments in infrastructure and are better able to make investments that improve the caliber of ser-

20. *Ibid.*, p. 28.

21. World Bank Group, *World Development Indicators 2001*.



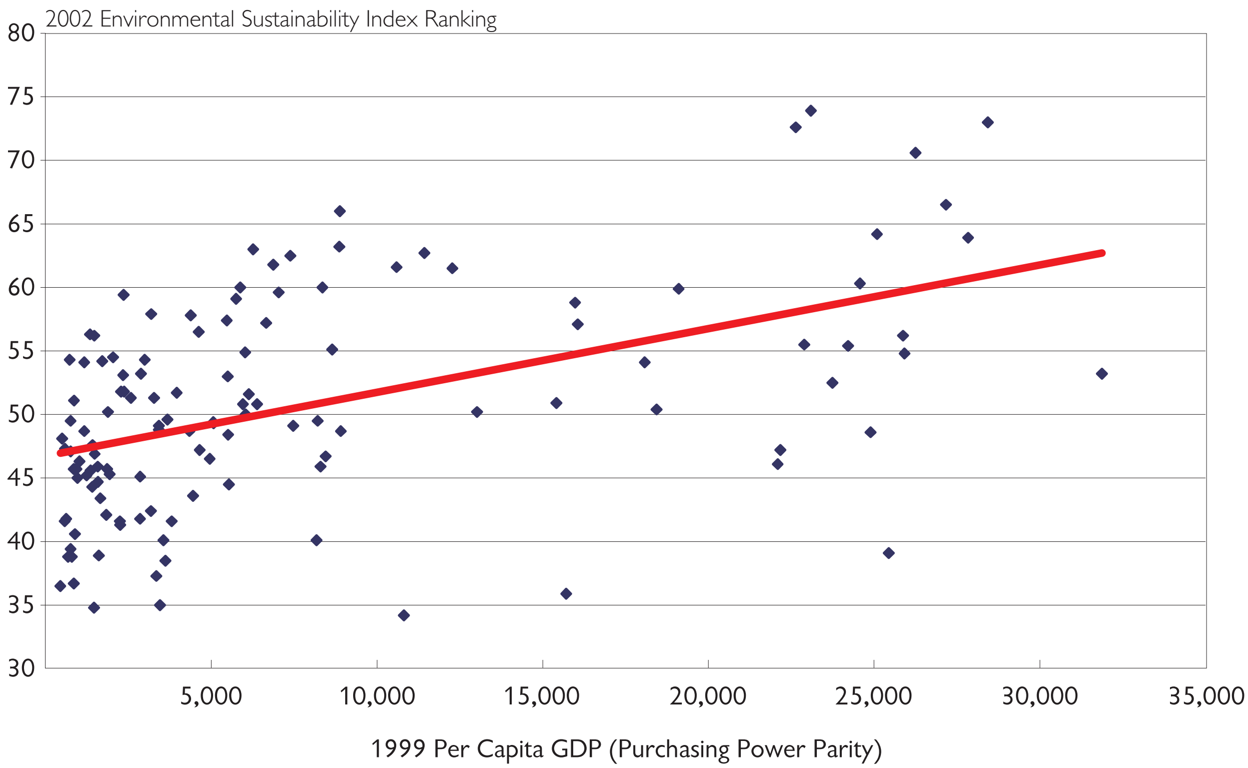
vices that are provided. Therefore, promoting economic freedom in a country:

- **Supports education.** Chart 2 shows that countries with higher per-capita incomes tend to have higher literacy rates. For example, in countries with per-capita incomes greater than $10,000, over 96 percent of the population is literate. By contrast, countries with a per-capita income between $0 and $1,000 have literacy rates of only 62.5 percent. Countries with higher per-capita incomes can afford to build more schools, hire more teachers, and allow their children to leave the labor force to attend school.
- **Raises health standards.** Higher per-capita income also provides more resources for individuals and the government to dedicate to health. As Chart 2 shows, residents of countries with per-capita incomes greater than $10,000 have a life expectancy of 77.3 years. By contrast, countries with per-capita incomes between $0 and $1,000 have a life expectancy of only 56 years—21 years younger than in the highest-income countries.
- **Protects the environment and raises labor standards.** Poor nations must focus on basic needs such as food and health care and cannot afford to be concerned with such matters as labor standards or environmental protection. However, as a country's income increases, so does its ability to make investments in these areas and implement measures that raise labor standards.

Chart 3 shows that countries with higher per-capita incomes have less incidence of child labor. For example, research by the World Bank Group revealed that, in countries with per-capita incomes above $5,000, the percentage of

Chart 4 B1546

Environmental Sustainability and Per Capita Gross Domestic Product (PPP)



Sources: World Economic Forum, CIESIN, and Yale Center for Environmental Law and Policy Environmental Sustainability Index, and *World Development Indicators 2001*, World Bank Group.

children between the ages of 10 and 14 who are working was less than 1 percent. By contrast, in countries with per-capita incomes between $0 and $1,000, the percentage of children between the ages of 10 and 14 who are working was as high as 21.7 percent. Similarly, in a paper written while she was a professor of economics at Stanford University, First Deputy Managing Director of the International Monetary Fund Anne Krueger demonstrated that per-capita GDP explains 80 percent of the worldwide variation in the incidence of child labor.[22]

Richer countries, on average, also have a more sustainable environmental policy than poor nations. The Environmental Sustainability Index (ESI) designates the health of a country's environment as a single number ranging from 0 to 100, with 0 representing the lowest sustainability and 100 the highest.[23] This number represents a country's success in coping with environmental challenges and cooperating with other countries in the management and improvement of common environmental problems. Chart 4 illustrates the relationship between per-capita income (in purchasing power parity) and the ESI. It shows that envi-

22. Anne Krueger, "Observations on International Labor Standards and Trade," National Bureau of Economic Research *Working Paper* No. 5632, 1996.

23. World Economic Forum, CIESIN, and Yale Center for Environmental Law and Policy Environmental Sustainability Index, January 2001, at *http://www.ciesin.columbia.edu/indicators/ESI/*.

ronmental sustainability increases with gains in per-capita GDP; the wealthier the economy, the greater the level of environmental sustainability.

In addition to the benefits that it provides by raising per-capita income, economic freedom has also proven beneficial as a prerequisite in:

- **Countering terrorism.** Although it is true that poverty itself does not cause terrorism, it is equally true that the countries that harbor terrorists are some of the world's most economically repressed nations. For example, in the *2002 Index of Economic Freedom*, four countries that were largely responsible for terrorism—Iran, Iraq, Syria, and Libya—were rated as "repressed" in terms of economic freedom. Other countries noted for terrorism, such as Afghanistan and Somalia, were not included in the *2002 Index of Economic Freedom* because "they are all so void of a rule of law that they are impossible to analyze."[24] As one important way to counter terrorism, America should encourage the governments of developing countries to embrace economic freedom.
- **Rooting out corruption.** The best way to eliminate corruption is to eliminate government intervention in the economy. Indeed, the *2002 Index of Economic Freedom* identifies corruption as an element inhibiting economic freedom with regard to six of the 10 factors used to measure the level of economic freedom in a country.[25]

  Government intervention creates incentives for individuals and businesses to engage in corrupt activities. For example, trade restrictions or excessive regulations create a situation in which citizens may bribe a customs or other government official to circumvent regulations. As demonstrated by economists Alejandro Chafuen and Eugenio Guzmán, economically free countries tend to have lower levels of corruption because minimizing government intervention lessens the incentives for corruption.[26]

RECOMMENDATIONS

President Bush is right to emphasize the need to reform aid to make it more effective. To accomplish this goal, the President should:

- **Allocate foreign aid based on improvements in economic freedom.** Research has shown that development aid can contribute to economic growth only when a country embraces economic freedom. The World Bank found that 1 percent of GDP in assistance given to countries that encourage economic freedom translates into a sustained increase in growth of 0.5 percentage point of GDP. By contrast, the Bank found that providing aid to countries with poor economic policies has a negligible effect on growth.[27]

  Even without this aid, however, there is evidence that economically free countries have higher per-capita incomes than economically repressed countries. Thus, progress in economic freedom has the potential to remove the need for development aid in the long term. As President Bush announced before the Monterrey conference:

  > Over time, [underdeveloped countries] will really no longer need [development assistance], because nations with sound laws and policies will attract more foreign investment. They will earn more trade revenues. And they will find that all these sources of capital will be invested more effectively and

24. Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Mary Anastasia O'Grady, "Economic Repression Breeds Terrorism," *The Wall Street Journal*, November 12, 2001.
25. The factors that include corruption are trade policy, capital flows and foreign investment, banking and finance, property rights, regulation, and black market.
26. Alejandro Chafuen and Eugenio Guzmán, "Economic Freedom and Corruption," in Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Melanie Kirkpatrick, *2000 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2000), p. 57.
27. Dollar and Pritchett, *Assessing Aid: What Works, What Doesn't and Why*, p. 15.

productively to create more jobs for their people.[28]

- **Stress the benefits of economic freedom.** Economic freedom has a salutary effect on the major priorities of both critics and proponents of development assistance. Economic freedom is the basis for catalyzing growth and, thereby, development in poor nations. This growth provides the resources that are necessary to raise education, environmental and labor, and health standards. In addition to the benefits that it provides by raising per-capita income, economic freedom has proven beneficial as a prerequisite in countering terrorism and rooting out corruption.
- **Administer the foreign aid in the Millennium Challenge Account through grants rather than loans.** One of the conclusions of the congressionally appointed International Financial Institution Advisory Commission (Meltzer Commission) on reforming the World Bank and International Monetary Fund was that development aid should be administered through performance-based grants rather than loans.[29] Under this system, grants would be disbursed not directly to the government, but to a non-governmental organization (NGO), charity, or private-sector business that offered the cheapest bid for a project. Moreover, the grants would be disbursed only after an independent auditor has verified the results of the project.

  This would increase the accountability and transparency of the system, showing how U.S. development assistance is being allocated and helping to ensure that U.S. taxpayers' dollars are being spent effectively. Furthermore, this approach would not burden underdeveloped countries with large debt at some future time.[30] The President should use the Millennium Challenge Account as a prototype to demonstrate that performance-based grants are not only possible, but also more effective than conventional development aid in raising standards of living and stimulating economic development.

  With this new approach to administering development assistance, President Bush would increase the level of accountability for how U.S. aid is administered to underdeveloped countries. Development assistance administered through performance-based grants would ensure that development funds are being devoted to projects that are producing results.

  Moreover, once the Administration chose a measure of economic freedom as a standard for the granting of development assistance, it would be easy to verify that aid is being administered to proper recipients: Countries that are making improvements in economic freedom should receive the most development assistance, while countries failing to make improvements should not receive development assistance. Because experience has demonstrated that aid is effective only in countries with sound economic policies, the success of this new approach should be determined by the Administration's ability to disburse development assistance to those countries that are making demonstrated improvements in economic freedom.

CONCLUSION

Rather than pouring additional funds into a system of aid that has proved unaccountable and ineffective, the Bush Administration should fundamentally reform the way in which the United States provides economic aid. The level of economic freedom in underdeveloped countries is more important to their economic progress than the amount of aid they receive.

28. "President Proposes $5 Billion Plan to Help Developing Nations."
29. *Report of the International Financial Institution Advisory Commission*, March 2000, at *http://www.house.gov/jec/imf/meltzer.htm*.
30. See Brett D. Schaefer, "Real Help for Poor Nations: President Bush's World Bank Grant Proposal," Heritage Foundation *Backgrounder* No. 1466, August 17, 2001, at *http://www.heritage.org/library/backgrounder/bg1466.html#pgfId=1154354*.

Once the success of a reformed system of bilateral aid is established, the President should promote it as a model for reforming multilateral aid policy through the World Bank and the International Monetary Fund. After 50 years of failure, it is past time to reform economic assistance to make it more accountable and effective by extending performance-based grants to countries, rewarding those that have taken verifiable action to improve their policy environments.

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